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British Airways: "Fit for Five?"

On the eve of transition of power from Rod Eddington to the new CEO designate at British Airways, Willie Walsh, once again we take a look at the group's strategy and the success at implementing that put in place some years ago.

The BA strategy has not changed that much in the past five years - except perhaps the public name of the strategy. At the annual investor day earlier this year the company announced that it was now calling its strategy "Fit for Five" in anticipation of moving all its operations into the new single terminal at Heathrow in 2008. It hesitated to explain or give any further details until next year.

Over three years ago the company introduced a strategic plan entitled "Future Size and Shape", which was a continuation of existing plan that had been in place for the previous three years. The company at the time stated that it had four main targets: 10% operating margins within three years; simplify the fleet structure and product proposal; compete with the no frills operators; resize staffing levels to a realistic level for the new environment. It also contained one promise "We will deliver".

It was in all appearance a continuation of the earlier strategy, with a full realisation that BA cannot operate its bases of operations at either Heathrow or Gatwick as a full transfer hub-and-spoke network operator. It must concentrate on maximising frequencies on core business routes and minimizing low performing routes. Although the strategy had highlighted the requirement to chase premium and business traffic and reduce exposure to leisure transfer passengers, the media had latched on to the idea that BA was spurning leisure passengers and cheap tickets. As for any full service carrier BA could never afford to turn away from a segment of the market; the publicity at the time probably had a deleterious effect on the appearance in the market of BA's leisure product. The main differences in this plan were the proposals to target the budget conscious passenger effectively once more and tell them about it.

The aim was that the plan would result in a 9% reduction in overall capacity (52% lower capacity at Gatwick), 10% higher short haul utilisation, 15% fewer destinations, 49 fewer aircraft, 40% fewer aircraft subtypes, and a total manpower reduction of 13,000. The financial aim was to generate a 10% operating margin by which under CVA it could show shareholders that it was creating value.

Last year the company emphasised a vision of "Customer Enabled BA". The company saw CeBA as a fundamental part of simplifying the business processes that is the core of its strategic aspirations. It described it as a multi-functional programme that would aim to cover the full process of the customers' experience from booking

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to returning home. As an essential element it would try to streamline the product offering in order to ensure consistency of delivery and elimination of duplication. In addition it does help that the internet is proving a viable way for the consumer to interact with internal systems without the intervention of any human agent.

How successful has BA been?

Capacity: At the end of March 2002 the company had 360 aircraft. At the end of June this year this number had fallen to 287 in operation. Admittedly seven of the fleet in 2002 were the Concordes and there have been some fleet alterations from the disposal of DBA among other elements. BA has also continued to streamline seating configurations in the fleet types to remove sub-fleet complexity. Actual capacity figures as published have not quite come up to aspirations with only a fall of 4% in seat capacity since Mar 2002 and a 1% fall in total capacity.

Profitability: Revenues in the twelve months to June 2005 touched just under £8bn, down some 4.7% from the £8.3bn achieved in the FY ended march 2002 (and some 14% from the peak revenues achieved in FY 2000/2001), but up by 4.2% compared with the 12 month period ending June 2004. Costs in the rolling period to June 2005 were some 12.6% below those in the financial year ended march 2002 (but 3% higher than those in the previous 12 month rolling period). The operating margin in the twelve months to June came in at 7.1% - a significant improvement on the negative 1.3% operating margin of FY2002 but just a little short of the 10% target "within three years".

Had the fuel price behaved itself the company would be well on track to achieve its targets. When jet kerosene was at its recent nadir it accounted for some 8-10% of a major airline's operating costs. Since then the price has nearly trebled. It seems unlikely in the short run (if ever) that the fuel prices will return to the halcyon days of only four years ago and that the industry will have to cope with a fuel burden to costs similar to that of that in the 1970s fuel crises. However for the moment fuel only represents a little less than 20% of BA's operating costs (after allowing for hedging policies) compared with staff costs accounting for some 30% of costs.

LCC competition: the company's website (ba.com) is the most innovative of all the major carriers' sites for online bookings. It also (given the complexity of a legacy carrier's operations) competes very successfully with the offerings of the low fare carriers. The initial aim was to provide the potential passenger with a simple way of finding the lowest fares available for a time that he or she may want to travel. It has (through judicious advertising) generated significant customer awareness of the competitive offering, and the ability to offer prices often well below those of the LCCs. When the company launched the service it limited some of its features to members of its FFP (the Executive Club). Since then BA has expanded the ability to check in online and print boarding cards to all passengers (for departures where self-printed boarding cards are legal or feasible). This is an unusual example of company-introduced cost savings benefiting the customer (as part of CeBA of course). Having given up the idea of trying to beat the LCC competition by fighting head on with like-for-like services, it may be the only legacy carrier to have effectively found a way of competing against them with only the marginal otherwise-unfilled-seats.

BA'S FLEET SIMPLIFICATION

	Jun 05	change	Mar 02
Concorde	-	-7	7
747-400	57	1	56
777	43	-2	45
767-300	21	-	21
757-200	13	-10	23
A319	33	-	33
A320	26	13	13
A321	6	6	-
737-300	5	-22	27
737-400	18	-13	31
737-500	9	-1	10
Turboprops	8	-36	44
Embraer RJ145	28	-1	29
Avro RJ100	16	-	16
BAe 146	4	-1	5
GROUP TOTAL	287	-73	360
ASK (bn,12 months rolling)	144.7	-4.2%	151.1
ATK (bn, 12 months rolling)	2.26	-1.0%	2.28

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LHR Terminal 5: the major opportunity

In 2008, after some 30-plus years of planning, Heathrow's fifth terminal is due to open. The topping-out ceremony took place recently so the building is now watertight. It has been agreed that British Airways will move all its Heathrow services into the new terminal along with those of most of its global partners.

At the moment the company operates services from all the other four terminals although most of its short haul services are operated from Terminal 1 and long haul (plus Paris and Amsterdam) from Terminal 4. As the new terminal is some five years later than was really required BA and partner services have been forced to operate from diverse terminals. This delay has created significant inefficiencies in the carriers operations at its home base.

The move will give the company a very strong boost in productivity at Heathrow. It will certainly help in its aim to simplify its business at the very base of its business itself. The cost saving from combining operations into one terminal at the moment is unknown - although next year BA may come up with some realistic figures - but is likely to be substantial. Moving all its operations (and those of its partners) into a single terminal allows it to rethink how a terminal operates and re-engineer its ground traffic flow management.

Simplification and empowerment

The company's strategy revolves around simplification, customer empowerment and cost savings in areas invisible or hidden from the customer. We would envisage that in the new terminal BA and the airport operator BAA in coordination redevelop the traditional flow of traffic through check-in to gate. BA will force (aka encourage) more of its passengers to book, ticket and generate boarding cards online (and incidentally increasingly move to charge those who do not).

It is feasible to imagine that BA will further develop customer empowerment for those who have used all the online services to allow them to move directly from kerbside to airside (via a bag drop-off point if necessary) by no more than electronic access. Security of course cannot be compromised and it seems nigh impossible to generate any savings of time or effort from what will continue to be a bottleneck in traffic flows through any airport. However, there are some possibly very good savings to be made from reducing and redirecting staff resources in the check in process.

The single terminal operation will additionally allow significant improvements in transfer baggage handling and tracking. It is likely also significantly to improve minimum transfer times. Although this is unlikely to provide sufficient savings to allow BA to compete effectively against the likes of Air France/KLM at Paris CDG and Amsterdam or Lufthansa at Frankfurt and Munich for transfer traffic and hub-and-spoke operations (even if it really wanted to) it is likely to improve the value and yield of such traffic it accepts.

Crewing, line maintenance, operations, catering: all will be directed to one end of the airfield which will remove some logistic inefficiencies from the current position. There should also be some efficiencies to gain in the use of office and other behind-the-scenes space within the terminal and consolidation of lounge and premium customer services - not only its own but also those of its oneworld partners.

Union issues

The move to Terminal 5 has been seen by some observers as an opportunity to tackle remaining restrictive working practices at the airline, or even to de-unionise the company. The difficulties of this approach are amply illustrated by the ongoing dispute at Gate Gourmet, BA's independent catering supplier. Following the dismissal of 670 strikers at Gate Gourmet (the former Swissair unit, now owned by Texas Pacific Group), all BA's flights have been left without inflight catering,

and, worse, BA workers joined an illegal sympathy strike in early September, causing flights to and from Heathrow to be halted for days, costing the airline up to £40m and doing considerable damage to its reputation after similar labour troubles in the two previous summers.

The Transport and General Workers' union represents the Gate Gourmet workers and thousands of BA's Heathrow ground staff. Against a background of internal power struggles at the union, the T&G leader Tony Woodley was under pressure to be seen to be tough in defence of members at Gate Gourmet (despite the firm being on track to lose £25m at Heathrow this year, a loss partly blamed on the contract signed with BA). BA was dragged into the dispute as Woodley argued that the airline trade unionists could not let one of BA's big suppliers treat its workers badly. An ulterior motive was also to remind the airline of the power of the union in the holiday peak season.

SkyWest and FLYi: RJ operators, contrasting fortunes

As fuel prices have again surged in recent weeks, creating havoc in the legacy carrier sector in the US, two of the nation's largest regional jet operators find themselves in oddly contrasting positions.

One of those companies, FLYi, the parent of Independence Air, is in a cash crisis, after struggling for over a year. FLYi is a likely near-term Chapter 11 candidate and, unlike the legacy carriers, is probably also headed for liquidation. "The end appears to be near", noted one Wall Street analyst when downgrading the company to "sell" on August 15.

By contrast, on that same day, cash-rich SkyWest announced a US$425m acquisition of Atlantic Southeast Airlines (ASA), one of Delta's two wholly owned regional subsidiaries. SkyWest has been consistently profitable, with one of the strongest balance sheets in the industry. The ASA purchase, which closed on September 8, has nearly doubled its size, making it the largest regional carrier in the US with a combined fleet of 372 aircraft.

Why the contrasting fortunes? Because the two airlines have adopted business models that have dramatically different fuel price risk exposures. SkyWest has opted to continue working with the legacy carriers, sticking with the safe fixed-fee feeder model that eliminates fuel price risk and guarantees profit margins. FLYi, in turn, disillusioned by the regional model and tired of the hassles of working with bankrupt partners, has rejected all that in favour of being an independent low fare carrier - probably the worst possible time to try such a strategy with a fleet of primarily 50-seaters.

FLYi's ill-fated transformation

FLYi's troubles date back to its decision, announced in mid-2003, to transform itself from a regional carrier into an LCC with a large independent hub operation at Washington Dulles. After previously operating as a feeder for United and Delta, and formerly known as Atlantic Coast Airlines or ACA, FLYi launched Independence Air in June 2004, initially with 50-seat CRJ-200s and since late 2004 also with 132-seat A319s. The airline terminated its United Express and Delta Connection operations by August and November 2004, respectively.

The past year has seen a complex fleet transformation, which has included retiring all 24 J-41 turboprops, passing 33 328JETs to Delta, returning 24 CRJs to lessors and adding 12 leased 132-seat A319s. In addition to the A319s, Independence Air currently operates 58 CRJs - down from a peak of 112 in 2003.

The airline uses the CRJs to offer fre-

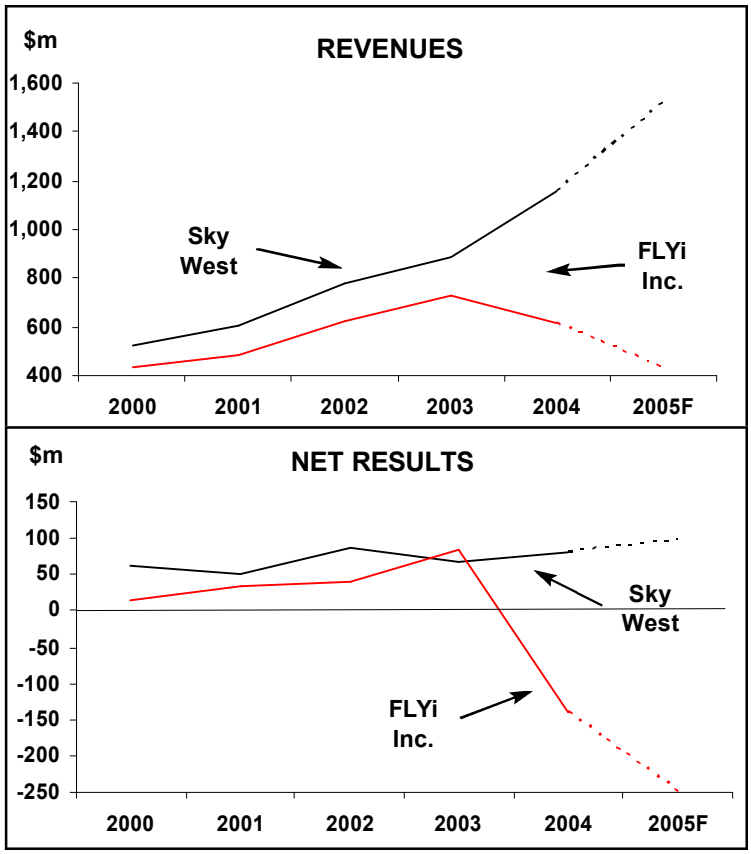
quent service on short haul routes and the A319s in larger, primarily long haul markets, including coast-to-coast. Currently, 44 destinations are served around the country. The product is in the up-market JetBlue mould, described as "reliable and easy to use air transportation with excellent customer service".

FLYi's efforts met with considerable scepticism right from the start, with the investment community being concerned about the high level of risk and untested economics. Those misgivings and the airline's reasons for making the switch were examined in a briefing in the September 2003 issue of Aviation Strategy and further discussed in the May 2004 and November 2004 issues. In essence, FLYi's leadership felt that the fixed-fee economics were deteriorating and that growth opportunities in the regional sector were diminishing.

Independence Air was extremely well funded to start with, with cash reserves of US$345m in June 2004. But, after a year of horrendous cash burn, unrestricted cash had dwindled to only US$66m at the end of June. The few analysts that still follow FLYi have concluded that, barring some miraculous rescue, the company is on course to run out of cash in the fourth quarter and therefore is likely to seek Chapter 11 protection before mid-October.

FLYi's revenues have declined by 41% in the past two years, from US$730.5m in 2003 to an estimated US$430.5m this year. The company posted a US$139m net loss before restructuring charges for 2004, representing a negative 22.6% net margin and contrasting with 2003's positive 11.3% margin. The First Call consensus estimate is that FLYi is headed for a net loss before items of US$250m, or 58% of revenues, in 2005.

In addition to the tough revenue environment and fuel (FLYi has had no fuel hedges), the airline has blamed the past year's losses on high transition and rebranding costs. It has an infrastructure and an overhead supporting a much larger operation. Also, FLYi has attracted less traffic than it had predicted, due to unexpectedly intense competition from United and



others. Because of that and its own significant capacity addition, its load factors remained in the 40s or 50s until recently.

There have seen signs recently that FLYi is finally establishing itself in the marketplace. Its load factors have recovered dramatically - July's was 79% and August's 72.2%. Also, the airline has ranked high in customer satisfaction surveys.

There was also reason to hope that increased use of the larger Airbus aircraft would help reduce losses - after all, like many of the US regional airlines, ACA was a lean and highly efficient operation and therefore potentially successful as an LCC. In addition to having much lower seat-mile costs than the CRJs, the A319s have given FLYi access to attractive new markets.

However, the recent load factor improvements appear to have come at the expense of yield. And the cost benefits resulting from increased A319 usage are totally obscured by an unexpectedly sharp fall in unit revenues. In fact, the negative CASM-RASM gap has widened over the

past year. In the second quarter, RASM plummeted by 48.3% year-over-year to 9.1 cents, while CASM fell by a lesser 31.5% to 13.7 cents.

In an attempt to remedy the problem, FLYi has decided to test the A319s in different markets. Beginning this month, the airline is cutting back transcontinental service (terminating Dulles-San Jose) in favour of using A319s in some of the higher-yield, short haul East Coast markets such as Boston. The airline has also reduced its total daily flights by 15% in the September schedule.

To conserve liquidity, in mid-August the airline deferred deliveries of six A319s that were scheduled for 2006. All of the 16 A319s on firm order will now be taken between the second half of 2007 and 2009. This facilitated an immediate US$31.2m cash refund (for pre-delivery payments already made) and deferred US$11.5m in further payments that would have been required this year. (In April FLYi exercised its right to cancel all of its 34 firm CRJ orders from Bombardier, which had been tied to the United Express contract.)

According to its latest quarterly report, FLYi is "re-evaluating the scope and nature of its Independence Air operations" and continuing to evaluate ways to address its liquidity needs. Initiatives under consideration include asset sales, such as the three remaining owned 328JETs and their spare parts inventory, additional issuance of equity or debt, and further debt or lease restructuring. FLYi had US$253.8m of long-term debt at the end of June.

However, there may not be any realistic options left in respect of debt or leases, because FLYi has already undertaken extensive restructuring this year. The company averted bankruptcy in February, when the majority of its CRJ lessors and debt providers and J-41 lessors agreed to restructure its lease and debt liabilities.

Merrill Lynch analyst Mike Linenberg has estimated FLYi's third-quarter cash burn at US$600,000 per day, which would reduce unrestricted cash to just US$12m by the end of September. Including the A319 deposit refund, cash would amount to US$43m, which Linenberg noted is a "dangerously low liquidity level to enter the December quarter, particularly if oil prices stay high".

Tough new revisions to Chapter 11 laws will take effect on October 17, so like other prospective bankruptcy candidates, FLYi is expected to file before that date.

FLYi's shares, listed on the Nasdaq (but currently under notice of non-compliance with listing requirements) have been trading at bankruptcy levels for quite some time. The share price fell steadily from the US$10-level in late 2003 to around US$4 in October 2004, when it plummeted to the US$1.50 level due to bankruptcy speculation. The price fell below US$1 in April and since early August has languished below 50 cents. Investors have had plenty of warning and many have got out in recent months. Wellington Management, one of the largest shareholders, liquidated its stake in FLYi in June.

FLYi's chances of attracting additional capital or emerging from Chapter 11 are much weaker than other airlines', because there are grave doubts about the viability of its business model. Arguably, the airline has not had a chance to properly demonstrate the strategy because of the fuel environment - among other things, the plans called for a much larger number of 50-seat CRJs. However, it is probably fair to conclude that 50-seat RJs are not viable for an LCC in the US, because the domestic market is so competitive and because a high fuel price environment is probably here to stay.

In many ways, the latest A319 deferrals have been the last straw, convincing analysts that FLYi will not achieve a competitive cost structure. Calyon Securities analyst Ray Neidl suggested that the A319 deferral "extinguishes the last possibility for management to make the business model work".

There have been repeated calls from analysts and investors for FLYi to give up LCC ambitions and go back to being a regional. When allocating new contracts some months ago, United also made it very clear that it would welcome FLYi back as a

feeder (in the process getting rid of an irksome competitor at Dulles). This might still be possible as an alternative to liquidation, though the opportunities are diminishing as other regional airlines have adopted aggressive growth strategies. Many people believe that the regional sector is ripe for consolidation.

Unfortunately, FLYi is too small to have much positive impact on industry capacity if it disappears. But there would be positive impact on pricing, because FLYi has been particularly disruptive on that front as it has desperately sought to fill its aircraft.

SkyWest's ASA purchase and growth opportunities

Utah-based SkyWest, which operates under fixed-fee feeder contracts for United and Delta, typifies the traditional successful US feeder airline. Effectively a "major" with US$1.2bn revenues in 2004, the company has been consistently profitable - last year it earned a net profit of US$82m, representing 7% of revenues. The First Call consensus forecast for 2005 (before inclusion of ASA's results) is a net profit of $97.4m or 6.4% of revenues.

While SkyWest and other US regional airlines have seen some deterioration in fixed-fee economics as their legacy partners have had to achieve cost savings, the impact on profit margins has been marginal. A report from Raymond James & Associates estimates that the guaranteed pretax profit margin in SkyWest's latest contract with Delta is 9%, which apparently is the new market rate. Previously, 10-11% seemed to be the norm.

Also, regional carriers now seem content in working with legacy partners that are in Chapter 11. When announcing the ASA deal, which makes SkyWest Delta's largest regional partner, SkyWest said that it was not concerned about Delta's potential bankruptcy because of its successful experience of working with United in bankruptcy.

All the indications are that the legacy carriers will continue to rationalise their fleets, retiring older smaller narrowbody aircraft, which will create continuing growth opportunities for regional airlines.

In other words, FLYi's views about the future of regional feeder operations are probably not justified. It is indicative that, after being roughly equal in size in 2003 (FLYi with US$731m revenues and SkyWest with US$888m), FLYi (with US$431m projected 2005 revenues) is now less than one third of SkyWest (US$1.5bn) and just one fifth of the SkyWest/ASA combination (US$2.5bn).

SkyWest has an industry-leading liquidity position: June 30 cash reserves of US$557m or about 37% of this year's revenues. The company is able to fund the ASA purchase from cash reserves, though it will probably opt for a partial debt financing. Long-term debt amounted to US$528.9m at the end of June.

The ASA acquisition, which closed more quickly than had been anticipated, is an important strategic move for SkyWest. The main benefits will be increased size and geographical presence, diversification and access to Atlanta, the world's largest hub, where ASA holds leases to 26 gates.

The two airlines will have a combined fleet of 372 aircraft, up from SkyWest's 221, plus 46 orders for delivery through 2007. They will have extensive presence nationwide, with primary hubs in Atlanta, Cincinnati, Chicago, Los Angeles, San Francisco, Salt Lake City, Denver, Portland and Seattle/Tacoma.

The deal will enable SkyWest to achieve a better balance in ASM production among its two legacy partners - something that was apparently desirable despite Delta's Chapter 11 risk. The current 35%/65% Delta/United exposure is expected to change to 59%/41% by the end of 2007.

The combined fleet includes 62 EMB120s, 229 CRJ200s and 69 CRJ700s, as well as 12 ATR-72s that will be eliminated by the end of 2007. The 46 firm orders are mostly for CRJ700s. In addition, Delta or Comair will lease to SkyWest/ASA 40 additional RJs, of which 22 will be 70-seaters.

As part of the deal, SkyWest's and ASA's existing Delta Connection contracts

were amended and extended until the end of 2020. Both will continue as fixed-fee agreements, which is the type of contract preferred by all regional airlines.

SkyWest appears to have taken great care to structure the deal and formulate its plans so that risks associated with mergers or Chapter 11 are minimised or even eliminated. To avoid the typical merger-related disruptions and hassles, SkyWest has decided to operate the two airlines separately for the foreseeable future. Since SkyWest is totally non-union and ASA is heavily unionised, it makes sense to keep the labour groups separate - there should be no problems particularly since SkyWest's pay and benefits are at least as good as ASA's. Nor are there plans to make any significant changes to schedules or aircraft deployment.

Nevertheless, SkyWest expects to achieve some synergies. The plan is to launch an intense "best practices" initiative to utilise the strengths of each airline. Top management positions will obviously not be duplicated - SkyWest's highly respected management team, led by Jerry Atkin as chairman/CEO, will take over at ASA.

The ASA purchase deal was structured so that Delta will have strong financial incentive to affirm the SkyWest and ASA feeder contracts in Chapter 11. When the deal closed, SkyWest only paid Delta US$350 of the US$475m total agreed (US$425 purchase price plus US$50m of returned aircraft deposits); the final US$125m will be paid after four years or if/when Delta affirms the feeder contracts in Chapter 11.

Of course, SkyWest's position as the leaseholder of 26 ASA gates in Atlanta would make it difficult for Delta to replace it with another carrier. SkyWest's leadership noted that those gates put it "in a needed position even if Delta files for bankruptcy".

SkyWest also made provisions to avoid the problem that FLYi initially had of getting stuck with aircraft leases when a partner terminates a feeder contract. SkyWest insisted that the 40-aircraft leases that are part of the ASA purchase deal will terminate at the same time as the contract if there is a material breach by Delta.

There is no doubt that SkyWest had an upper hand in the negotiations, which had lasted for six months but were concluded when Delta was truly desperate. In addition to getting its conditions approved, SkyWest got ASA for a bargain price - Delta itself paid US$700m in 1999 for the 80% stake of ASA that it did not already own.

The deal has been generally welcomed on Wall Street, with analysts noting the likely substantial positive impact on SkyWest's earnings from 2006. However, SkyWest's shares may remain volatile until Delta affirms the feeder contracts in Chapter 11.

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China's Big Three - The rise of competition

The Chinese government is increasing the pace of aviation liberalisation, but as competition increases and fuel prices rise, the Big Three airlines - Air China, China Eastern and China Southern - are facing a difficult year.

Although the Big Three all saw an improvement in financial results in 2004 compared with SARS-affected 2003, many analysts believe this year's figures may be disappointing. The major reason for this pessimism is rising fuel prices - the government regulates fuel supplies in China, with the result that it is up to 20% more expensive than on the global market. In addition, the government has (so far) barred Chinese airlines from levying fuel surcharges. China Southern and China Eastern in particular could both could plunge into a loss this year as a result of rising fuel prices, and both airlines' shares have fallen by almost one-third so far in 2005 (although Chinese airlines tend to perform better in the second half of the year than in the first, so share prices could recover).

While the Big Three airlines hope higher fuel prices are a short-term phenomenon, of much greater impact in the long-term will be the effect of increasing competition - both between themselves, from the first handful of Chinese LCCs, and from increasing competition from foreign airlines such as Lufthansa and United.

This rise in competition is part of the increasingly liberal (or, more accurately, less state-controlled) aviation policies from the Chinese government, due partly to increasing pressure from the US and the EU, and partly to the need to be prepared for the 2008 Beijing Olympics.

Now that the government has completed the restructuring of the aviation industry it launched four years ago (which involved the Big Three swallowing up many smaller airlines), it has started to examine other areas. Liberalisation has included:

• Allowing the Big Three to challenge their rivals at their home hubs.
• Giving Chinese airlines greater freedom to reduce fares.
• Examining the extension of an open skies policy that was introduced successfully in the Hainan region in 2003 into other provinces.
• Allowing the first direct flights between China and Taiwan for more than 50 years.
• Signing more liberal bilaterals; for example, a bilateral with the US in 2004 allowed two new airlines - Continental and American - to join existing US carriers United and Northwest on routes to China.
• Agreeing to negotiate later this year with the European Commission on a pan-European air services agreement that would replace 22 existing bilaterals with EU counties (many of which have been signed in the last two years and have allowed new direct services into China).

The start-ups

In addition, the government has agreed to allow start-up carriers in China, and so far four have launched or are in the process of launching. These are:

• **Okay Airways**, based in Tianjin and which started domestic charter operations in March with a 737-900 on lease from Korean Air (which intends to buy a stake in Okay). However, Okay's plans to offer low fares have apparently been hit by high landing fees out of Tianjin.
• Shanghai-based **Spring Airlines**, owned by a Chinese travel agency and which aims to become China's first LCC after launching domestic routes in July with an A320 leased from GECAS. Spring offers a no-frills service, only offers seats via the internet and has plans for a fleet of 15 aircraft by the end of 2008. However, reports out of China indicate that it is having to increase its fares after protest from other airlines,

• Chengdu-based **United Eagle Airlines**, which launched its first domestic route in July using the first of four A320s it plans to lease from GECAS.
• **East Star Airlines**, based in Wuhan and owned by tourism group China East Star and which will launch routes to domestic destinations including Beijing, Shanghai and Guangzhou this autumn using 737s or A320s.
• Shanghai-based **Eastern Express**, a scheduled, charter and cargo carrier that has yet to announce a launch date but which is owned by a syndicate of Chinese firms.

Government policy

Despite these developments, there is still a long way to go in the government's liberalisation drive. For example, foreign airlines are not allowed to own more than 25% of a Chinese carrier, while late last year the government capped deliveries of new aircraft to China in 2005 to 147 in order to allow airlines time to "improve safety standards" - although this will not halt the boom in the fleet as it applies for one year only.

More seriously, the government needs to increase the pace of infrastructure improvements. Aircraft movements at Beijing airport, for example, will rise from 680 a day today to a forecast 1,920 a day by 2023. But even the governments current plans to build 55 more airports in China by 2020 may not build up infrastructure capacity quickly enough. And there are growing problems with recruiting enough skilled staff. According to the Civil Aviation Administration of China (CAAC), China needs 12,000 new pilots in the next eight years, and already a shortage of pilots has forced some airlines to recruit from abroad. Shanghai Airlines is one of several carriers that have delayed taking delivery of new aircraft due to personnel shortages.

And China is still under pressure (particularly from the US) to revalue the yuan significantly. It was fixed at 8.28 yuan to the US dollar until July, when it was revalued to 8.11 after being pegged to a basket of currencies. Although the move was a symbolic first step towards a free float, the US wants a much greater appreciation. Revaluation broadly benefits the Big Three as their financing and operating costs fall. China Eastern, for example, calculates that it will save between $12m and $18m a year in interest on its debt for every 1% that the yuan appreciates, while in June Deutsche Bank estimated that a 5% revaluation of the yuan would increase China Eastern's 2005 pre-tax earnings by 235%.

In relative terms, however, concerns about rising fuel prices, increasing competition and inadequate infrastructure are insignificant given the continuing confidence about the prospects both for the Chinese economy and the aviation market in the long-term.

China's GDP has grown by 8.6% on average each year for the last decade, and according to the CAAC passengers carried in China rose 39% last year, to 120m, of which 100m were domestic. Yet the potential of the domestic market remains huge - whereas every US citizen makes, on average, 2.2 air trips every year, the figure for Chinese citizens is just 0.06 trips per year. Of course, the majority of China's 1.3bn population are rural and are unlikely to be able to afford to travel by air even in the long-term, but according to the Chinese government around 250m Chinese are classified as having a "middle-income", defined as households with between $18,000 and $36,000 of assets. That's 19% of the overall population, and this figure is forecast to rise to 40% by 2020. More importantly, today 50% of those living in China's cities are already in this middle-income category, and thus the prime target market for Chinese airlines.

Domestic air travel has multiplied 20 times between 1980 and 1998, at an average growth rate of 16.5% per year, and Ma Xulun, the president of Air China, expects Chinese air travel to rise by up to 15% a year for the next five years. And while there were 1bn train journeys in China last year, most of these were local, as with distances being so great in China high-speed trains do not provide the same competition that they do, for example, in Europe. A Beijing-Guangzhou HST service would take 9 hours, for example.

On top of the domestic market, there's

also huge potential for overseas travel. According to the World Travel and Tourism Council, more than 100m Chinese will travel internationally each year by 2020. International travel demand out of China has been reigned back by the government's restriction on countries that its citizens are allowed to visit (the so-called Approved Destination List), but that number now stands at 55 after 27 European countries were added to the list last year.

The Chinese fleet

The Big Three airlines (excluding non-integrated partners) continue to dominate the Chinese fleet, accounting for a substantial 66% of the total mainland Chinese fleet in 2005. This continues the increase in fleet share seen in the 2000s, from a low of 36% in 2002. In absolute terms the Big Three now operate 545 aircraft, a 40% increase from 390 aircraft in 2004. And despite the rise in start-ups, the Big Three's dominance is set to continue as they currently have 162 aircraft on order, out of total outstanding Chinese fleet orders of 227 aircraft. That compares with just 63 orders 12 months' previously, and is an indication just how much of an emphasis the Big Three have put on expansion over the last year.

Boeing accounts for 568 aircraft (or 58%) out of the total Chinese fleet, with Airbus having 295 aircraft (30%) and others 113 aircraft (12%). Airbus has 162 outstanding orders in China, more than doubling its order book in the last 12 months. 107 of them are for A320 family aircraft (with 50 of them being made in the last 12 months) and 48 are for the A330 (35 in the last year).

In contrast, Boeing's order book has inched up (in relative terms) from 58 aircraft in 2004 to 64 in 2005. All but seven of Boeing's outstanding orders are for 737NGs. However, Boeing's position will be strengthened considerably when part of a framework order for up to 60 787s from Chinese airlines is firmed up (due as *Aviation Strategy* went to press).

For the moment, 737s continue to be the dominant type in the overall Chinese fleet, with 330 aircraft (34%), followed by the A320 family with 186 aircraft (19%), though again, this gap is narrowing as the older 737s are retired and Airbus's dominance in new short-haul aircraft orders is reflected in the delivered fleet.

According to Airbus's latest forecast (released in December 2004, in which it devotes no less than seven pages to the Chinese market), Chinese airlines will need 1,790 new aircraft over 2004-2023, worth an estimated $242bn in 2004 dollars. That's a huge uplift on Airbus's forecast a year before, when it forecast 1,530 new aircraft worth $176bn over the following 20 years.

Airbus's emphasis on China contrasts with Boeing, which - frustratingly - omits any specific mention of estimated aircraft orders for China in its latest forecast, released in June 2005. Boeing previously broke down forecasts orders by countries, but this year has kept figures at an aggregated, regional basis (i.e. China is rolled into the Asia-Pacific region aircraft forecast). Curiously, even Boeing's own China website contains a "Boeing and China pamphlet" that dates back to 2002 and talks about forecasts for the years 2001-2020. Hopefully, Boeing's sales presence on the ground in China is better than its current marketing collateral.

Boeing has also been hit by US trade policy, whereby tariffs on exported aircraft parts have led to rising maintenance costs for Chinese airlines that have large Boeing fleets (which is most of them). In an attempt to mitigate the effect of this politically, earlier this year Boeing signed contracts worth $600m with Chinese manufacturers to build parts for its 737 and 787 programmes. Airbus also allows local manufacture of A320 components, and is likely to agree a similar tie-up for A350 production.

Air China

Beijing-based Air China, the national flag carrier, operates a fleet of 143 aircraft to more than 115 destinations, of which one-third are international. Air China is also the largest cargo airline in China, owning 51% of Air China Cargo,

Air China has traditionally been seen as the weakest of the Big Three, due to perceived government interference, but that view appears to be changing now that it has finally joined its main rivals by listing on the London and Hong Kong stock exchanges (after three previous postponements in the 2000s) in December 2004.

Advised by Merrill Lynch and China International Capital Corp, Air China was successful in selling 31% of its equity and raising $1.1bn. Air China is using $580m of the IPO proceeds to fund the purchase of aircraft, while the rest is to pay off long-term debt. The retail part of the float was oversubscribed 83 times and the institutional part 40 times, and as a result of overwhelming demand the retail share was increased from the planned 10% to 40%. Institutional investors bought 27.5% of the float, while Cathay Pacific acquired 32.5%, giving it a 9.9% share of Air China overall.

Although Air China listed at a discount to its two rivals (it was priced at a forward P/E ratio of 10.9, compared with 11.4 for China Eastern and 14.5 for China Southern),

Air China's market capitalisation is now approximately $3bn - higher than China Eastern ($1bn) and China Southern ($1.7bn) - and some analysts now consider Air China as a better long-term bet than its two rivals.

Part of that optimism stems from the benefits Air China will receive from the Beijing Olympics of 2008. The airline currently accounts for just under 50% of all traffic to/from Beijing, and will get a huge boost to its revenues from the event. In preparation, Air China plans to expand its fleet by almost one-third by 2008, and these may include two leased A380s, which Air China is believed to be negotiating with ILFC. Aircraft currently on order include 15 787s (due to be confirmed), 10 A320 family aircraft and 16 737NGs. In January this year Air China also ordered 20 A330-200s, for delivery in 2006-2008 and worth $2.9bn at list prices. They will partly replace existing aircraft and partly be used for new long-haul routes.

CHINESE AIRLINE FLEETS

	737-2/300	737-4/500	737NG	747-2/300	747-400	757	767	777	A300/310	A320 family	A330	A340	A380
Air China	33		29 (16)		12	13	14	10		21 (10)	(20)	6	
Air China Cargo				4	1 (2)								
Air Hong Kong									9 (2)				
Air Macau									3	13			
Cathay Pacific				7	25			16 (1)			25 (4)	18	
Changan AL			4										
China Cargo AL					(2)								
China Eastern AL	25		28 (8)				3		16	69 (24)	(20)	10	
China Postal AL	2												
China Southern AL	30	12	24 (11)		2	29		10	6	46 (48)	4		(5)
China United AL	6		2										
China Xinhua AL	6	3	2										
CR Airways													
Deer Jet	2												
Dragonair				4	1					17	12 (4)		
Guizhou AL	1												
Hainan AL	5	7	17 (11)				5			(8)			
Okay AW			1										
Shandong AL	13		2 (5)										
Shanghai AL	1		16			13	5 (2)						
Shanxi AL			3										
Shenzhen AL	9		19 (4)							1 (6)			
Sichuan AL										17 (11)			
Spring Airlines										1			
United Eagle AL										1			
Xiamen AL	4	6	13 (2)			9							
Yangtze River Express	5												
Total	**142**	**28**	**160 (57)**	**15**	**41 (4)**	**64**	**27 (2)**	**36 (1)**	**34 (2)**	**186 (107)**	**41 (48)**	**34**	**(5)**

However, the Olympics also represent a threat to Air China, as they are attracting even greater interest in the Chinese market from foreign airlines. More than 80 foreign airlines currently operate into China, and that figure is rising. In an effort to combat this Air China is investing $83m in renovating its first and business classes on 15 long-haul aircraft by the end of 2005.

Air China is also in negotiations to join Star, which has long been seen as a natural global alliance for the airline, although new minority holder Cathay Pacific, a member of oneworld, may complicate the issue. Cathay chairman David Turnbull joined the Air China board in May, the two airlines will link their FFPs in the third quarter of 2005, and later in the year they will begin codesharing between Beijing and Hong Kong.

Earlier this year there was much speculation that the growing ties between the two would lead to a "mega merger" whereby Air China and Swire Pacific (owner of 46% of Cathay Pacific) exchange equity. Although this would give Air China access to better management expertise at Cathay, such a deal will be tricky both politically and in terms of regulatory issues, and such a possibility was denied by both airlines (although negotiations between the two were held).

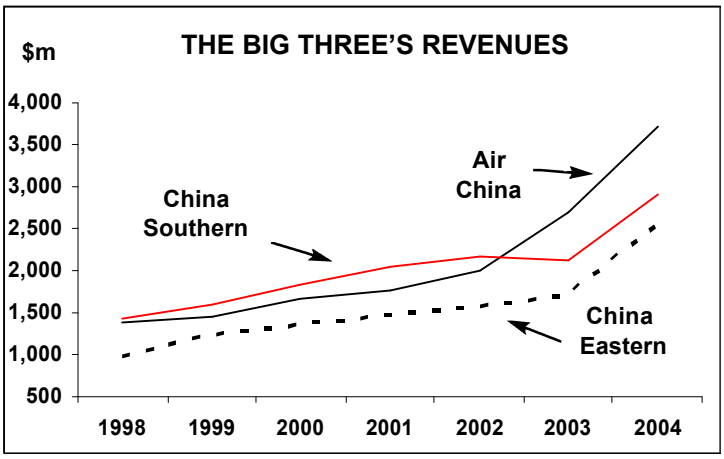
Although it is likely that Cathay will buy a stake in a Big Three carrier at some time in the future, apparently a more likely deal in the short term is that Air China sells to Cathay its 43% stake in Hong Kong-based Dragonair (held via China National Aviation Company, of which Air China owns 69%). Cathay already owns 18% of Dragonair (which expanded its existing codeshare deal with Air China this year) and may see control of the airline as the best way of expanding its network into China. Cathay operates to a handful of destinations in mainland China, while Dragonair has more than 20 routes.

Even if a merger does not take place, closer Air China/Cathay ties are a serious threat to the other main Chinese airlines, as they provide a seamless connection for the large mainland-Hong Kong market. And Air China is also planning to open hubs in Shanghai and Guangzhou, the backyards of China Eastern and China Southern.

Air China also recorded its best ever set of financial results in 2004, with a net profit of $289m (higher than forecasted in its own IPO prospectus), compared with just $11m in 2003, and based on a revenue of $3.7bn ($2.7bn in 2003). The airline implemented a series of cost cutting measures in 2004 (and aims to cut costs by $120m over the next three years), but the majority of the boost to its bottom line in 2004 came from substantial traffic increases on both international and

CHINESE AIRLINE FLEETS (cont.)

	MD11	MD80	MD90	Russian	Other	Total
Air China				5		**143 (46)**
Air China Cargo						**5 (2)**
Air Hong Kong						**9 (2)**
Air Macau					2	**18**
Cathay Pacific					1	**92 (5)**
Changan AL					2	**6**
China Cargo AL	6					**6 (2)**
China Eastern AL		3	9	7	15	**185 (52)**
China Postal AL						**2**
China Southern AL		23	13	12	6	**217 (64)**
China United AL				2	9 (1)	**19 (1)**
China Xinhua AL						**11**
CR Airways					2	**2**
Deer Jet					1	**3**
Dragonair						**34 (4)**
Guizhou AL						**1**
Hainan AL					28	**62 (19)**
Okay AW						**1**
Shandong AL					10	**25 (5)**
Shanghai AL	1				5	**41 (2)**
Shanxi AL					1	**4**
Shenzhen AL						**29 (10)**
Sichuan AL					5	**22 (11)**
Spring Airlines						**1**
United Eagle AL						**1**
Xiamen AL						**32 (2)**
Yangtze River Express						**5**
Total	**7**	**26**	**22**	**26**	**87 (1)**	**976 (227)**



domestic routes. Passengers carried rose 36% to 24.5m in 2004, with RPKs up by 39%, ASKs by 28%, and load factor rising to more than 70%. Although no financial figures are yet available for the first half of 2005, passengers carried in the period rose 13% to 12.6m, with load factor up by 3.3 percentage points to 71.9%.

Looking to 2005, Air China plans to distribute up to 30% of profits made this year as dividend to shareholders, while Air China is also issuing $423m of 10-year bonds this year to part finance the purchase of the A330-200s ordered in January. The aircraft will be used partly for an ambitious expansion of European services, where Air China plans to double frequencies within five years to all seven existing routes.

Air China is also looking to make further strategic acquisitions. It bought 23% of Shandong Airlines in February 2004 and in October last year Air China also purchased 51% of Air Macau, It is also reportedly negotiating with the Peruvian government to buy up to 70% of the TANS airline.

However, in May this year Air China lost out on its bid to buy a 65% stake in Shenzhen Airlines (in which it already has a 25% stake) after it pulled out in the 93rd round of an auction held by the Guangdong Development Bank. The airline is based in the south of China and operates 29 aircraft on more than 80 domestic routes. It is a regional competitor to China Southern, and its acquisition would have been a major boost for Air China. However, Air China pulled out after bidding $328m, leaving the winning bid to a joint venture from two investment companies - the Yi Yang Group and Huirun Investments - who offered $329m. Shenzhen has 10 aircraft on order and ambitious expansion plans to build up a fleet of 100 aircraft within the next five years. It was the only Chinese airline to stay profitable through the SARS crisis, and in 2004 posted a net profit of $24m. Air China now says it will sell its 25% stake in Shenzhen.

Air China also faces bad news elsewhere. Although Air China hedged 25% of its fuel needs for international routes in 2004, as Chinese airlines are effectively not allowed to hedge fuel needs for domestic operations (thanks to a domestic monopoly supplier), rising oil prices meant that Air China's fuel bill rose by 54% in 2004 to more than $1bn. Fuel accounted for 29% of operating costs in 2004, compared with 24% in 2003, but this year Air China has not been able to hedge any of its fuel costs, to the alarm of some analysts. Air China is lobbying the Chinese government hard to allow it to introduce a passenger fuel surcharge.

Another problem arose this summer when more than 400 travel agents in Guangzhou boycotted discounted tickets that Air China offered on selected flights (with fares up to 70% lower than normal) after coming under pressure from other airlines - including China Southern and China Eastern - which allegedly threatened to remove the agencies from their distribution networks.

China Southern

Guangzhou-based China Southern has the largest network of the Big Three, operating more than 300 routes to over 100 destinations with a fleet of 217 aircraft. This includes 66 737s and 46 A320 family aircraft, while on long-haul in June Southern received the last of four A330s it ordered in 2003 (it was the first Chinese airline to order and receive the type).

China Southern also has the biggest order book of any Chinese airline - 64 aircraft. In January it became the first of Big Three to order the 550-seat A380, and the first of five aircraft will arrive in 2007 (in time for the

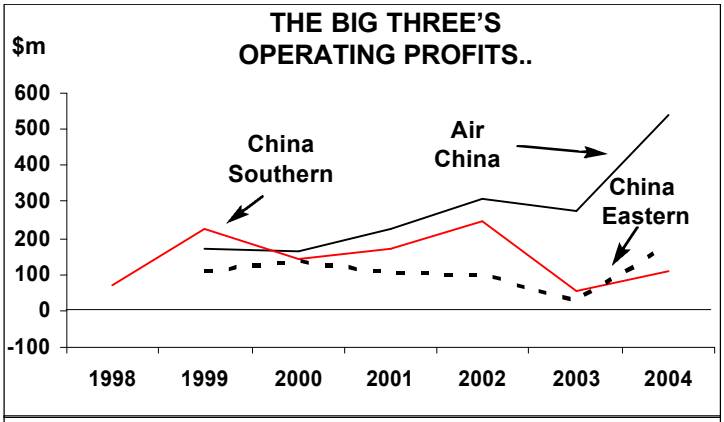
Olympics of 2008), with deliveries due to be completed by 2010. The aircraft have a list price of $1.4bn. In the same month China Southern provisionally ordered 13 787s, to be delivered from 2008 onwards, with three of them destined for Xiamen Airlines, of which it owns 60% (although there are unconfirmed reports that China Southern wants to reduce the number of 787s when the firm order is confirmed later this year.)

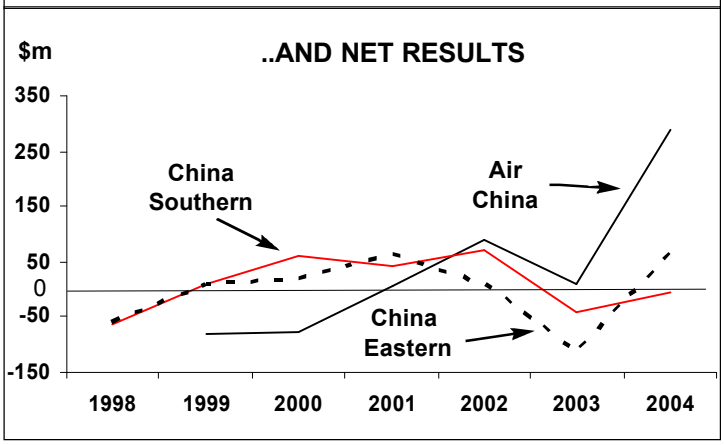
But the orders didn't stop there. Earlier in the year China Southern agreed to lease five 737-700s, five 737-800s, five A320s and 10 A321s from ILFC, for delivery in 2006 and 2007, as well as nine 737-800s from GECAS, for delivery in 2005 and 2006. A deal for 23 leased A320s was also signed with ILFC at the end of 2004. The lease deals come as a direct result of the Chinese government's restrictions on the overall amount of aircraft that Chinese airlines are allowed to import in any one year. Altogether, China Southern is committed to capex of $1.9bn in 2005 and 2006 alone - and in order to crew the expanded fleet, China Southern is also doubling its intake of trainee pilots every year to 250.

The ambitious fleet expansion comes as China Southern is under increasing attack from its Big Three rivals. Guangzhou's new Baiyun airport opened in August 2004 and is the largest airport in China, but both China Eastern and Air China have received permission to set up hubs there as well, while another airline - Shanghai Airlines - is also pressing the government to let it in.

That's particularly worrying because of all the Big Three, China Southern is the most dependent on the domestic market, with 80% of revenue in 2004 coming from the domestic sector (compared with 54% at China Eastern and 39% at Air China).

However China Southern is trying to reduce its dependence on traffic in and out of Guangzhou. It already owns 49% of China Postal Airlines, 60% of Guizhou Airlines, 60% of Shantou Airlines, 39% of Sichuan Airlines and 60% of Xiamen Airlines, and in late 2004 it completed the purchase of China Northern Airlines and Xinjiang Airlines from its parent (China Southern Air Holding) for $2bn, as well as assuming $1.8bn in debt at the two airlines. This was part of the government's





restructuring of the aviation industry, and the acquisitions have boosted China Southern's network in the north east and north west areas of the country respectively, where it previously didn't have much presence. The acquisitions also boosted China Southern's fleet by 70 aircraft, and will increase passengers carried at the airline to more than 40m a year (as well as extending the airline's share of the domestic market from approximately 26% to 34%). China Southern is also counter-attacking Air China by spending more than $130m on a new hub at Beijing, which will open in 2007.

China Southern's international routes are focussed on the Asia-Pacific region, with a handful of routes to Europe and North America. But its international kudos was boosted considerably by the order for the A380s, which are both a symbolic and actual challenge to the traditional long-haul dominance of Air China, the only mainland Chinese operator of the 747-400. China Southern is also likely to become the first of the first of Big Three to join a global alliance,

with SkyTeam membership likely in 2006. China Southern already has codeshare or other links with KLM, Delta and Korean Air, and in April China Southern and Northwest Airlines started a joint marketing programme, including reciprocal FFPs. An FFP tie-up was also signed with Air France at the end of 2004; China Southern's FFP - called Sky Pearl - has 2.5m members and is the largest of the Big Three. A joint venture between China Southern and Air France on France/China routes is also under negotiation.

The international focus follows a surprising set of financial results for 2004. Despite having a profitable first three-quarters of the year, China reported a net loss of $6m for 2004, less than the $43m loss of 2003 but a disappointment given that analysts were expecting a profit for the year. Fuel costs (which account for 30% of all costs) rose by 57% in 2004, but other costs rose too, largely due to expansion by the airline. Revenue rose 37% to $2.9bn in 2005, while operating profit doubled, to $110m. Passengers carried rose 38% to 28.2m, ASKs grew by 32% and RPKs by 41%, with load factor rising 4.6 percentage points to 69.2% in 2004.

Worryingly, China Southern stated that the "sustained high fuel price ... might climb even higher", and the airline is implementing various cost-cutting programmes in 2005. But with a larger domestic presence than its rivals, China Southern's aircraft have fewer opportunities to refuel at overseas airports. Additionally, China Southern will have substantial costs from the integration of China Northern Airlines and Xinjiang Airlines into its operations

Prospects for 2005 do not look good, as China Southern has just announced a net loss of $112m in the first half of the year (compared with a $33m net profit in 1H 2004). That was despite a 52% increase in passengers carried in the half year - with a 1.7 rise in percentage points in load factor, to 68.2% - and a 61% jump in operating revenue. But thanks to the substantial rise in fuel costs compared with January-June 2004, operating costs rose by more than 75%, and China Southern recorded an operating loss of $52m (compared with an operating profit of $93m in January-June 2004). The airline states that it "intends to meet the challenge of soaring fuel prices by using economies of scale and strict control over operating costs increases".

China Eastern

Shanghai-based China Eastern returned to the black in 2004 with a net profit of $62m, compared with a net loss of $115m in 2003, and an operating profit of $179m ($27m in 2003). Revenue was up 47%, to $2.5bn, with 17.7m passengers carried in 2004, 44.7% up on 2003. RPKs grew by 50.9% in 2004, well ahead of the ASK increase of 37.4% and resulting in a 5.9 percentage point rise in load factor, to 66.3%. The biggest growth was in international services, where RPKs leapt by 73.9% in 2004, while domestic RPKs were - in relative terms - up by just 37.2%.

However, China Eastern also disappointed analysts after rising fuel costs (up by 78% compared with 2003) resulted in a set of results that were lower than the consensus forecast, despite the implementation of cost-cutting programmes. There is also increasing worry about the level of debt at China Eastern, which now stands at $3.8bn, giving it a gearing level of 82%. The debt level has risen considerably in recent times due to a substantial increase in the size of the fleet.

China Eastern currently has a fleet of 185 aircraft, and it has 52 more on order. In fact the increase in China Eastern's order book has been staggering. In October 2004 it ordered 20 A330-300s - its single biggest order since 2002 - for 2006-2008 delivery and at a cost of $3.4bn. The aircraft will replace existing A300s and A310s. In December it ordered six 737-700s for 2006 delivery, in March this year it ordered five A319s for 2006-2007 delivery, and in April it ordered 11 A321s and four A320s for delivery in 2006-2008. In January this year China Eastern also signed a framework deal for 15 787s, to be delivered from 2008 and part of the bulk order for 60 787s worth $7.2bn placed by China Aviation Supplies Import and Export Group. For regional operations, five ERJ-145s were ordered in March at a cost of $110m, for delivery in 2005-2006 and to be built by Harbin

Embraer, the China-based joint venture company.

Its fleet was also boosted considerably this summer when the airline completed the purchase of China Northwest and Yunnan Airlines from its state-run parent for a combined price of up to $119m (as well as taking on debt totalling $1bn). Some analysts criticised the move, claiming that China Eastern overpaid its parent given the amount of debt it was also assuming. However, as the move was the last part of the government's restructuring of the aviation industry, China Eastern had little say in the matter.

The acquisitions more than doubled the number of destinations served by China Eastern (from 238 to 503), boosted the airline's share of the domestic market from 19% to 23%, and increased its fleet by 64 aircraft, (overtaking Air China in fleet size). The two acquired airlines were an important boost to China Eastern's domestic assets - China Eastern also owns 63% of China Eastern Airlines Jiangsu, 40% of China Eastern Airlines Wuhan and 70% of China Cargo Airlines.

But China Eastern is under attack at its main hub, Shanghai, into which Air China is now expanding. Additionally, China Eastern is vulnerable at Shanghai given that it has to transfer passengers between international flights arriving at Pudong airport and domestic flights operating out of Hongqiao. A solution will only be possible in 2008 when a second terminal opens at Pudong, which China Eastern plans to dedicate to domestic services. But one piece of good news domestically came in April when China Eastern received permission from the government to set up a hub at Guangzhou's new Baiyun airport, a direct challenge to China Southern.

China Eastern continues to open up new international routes - services to London Heathrow and Vancouver were launched in 2004, and this year routes have started to Moscow, Bombay, Los Angeles and Dhaka in Bangladesh. Also in 2004 China Eastern opened a new international hub in the northeastern city of Shenyang, with eight routes to Europe, Asia and North America, all going via Shanghai. China Eastern also linked FFPs with Taiwan's China Airlines in late 2004 - the first such cooperation between Mainland Chinese and Taiwanese carriers. And China Eastern started codesharing with Air Europa on the Spanish airline's services between Shanghai, Beijing and Madrid in May this year. That follows the increase in permitted weekly flights between China and Spain from two to 21 at the end of 2004 - a sign that competition on many international routes will only increase.

China Eastern has held talks in 2005 with prospective strategic partners, although the airline refuses to confirm speculation that Singapore Airlines and Japan Airlines (with which China Eastern expanded an existing codeshare this summer) are two of the airlines believed to be considering an investment. The airline has a longstanding relationship with Cathay Pacific, but this is unlikely to result in an equity tie-up given Cathay's investment in Air China, a move that according to Li Fenghua, Chairman of China Eastern, was "a little bit unexpected".

The cooling in the relationship is believed to have begun when Cathay Pacific became upset about perceived lack of support by China Eastern for Cathay's attempt to win Chinese government approval to enter the lucrative Shanghai-Hong Kong route. Significantly this may derail what been previously been thought of as China Eastern's inevitable membership of the oneworld alliance (given its partnership with both Cathay and American). But there are few alternatives for China Eastern, given the likely tie-ups between China Southern and SkyTeam, and Air China and Star.

Despite a rise of 6% in passengers carried and 7.8% in RPKs during the first six months of 2005, rising fuel prices led China Eastern to post a net loss of $59m for the half year, compared with a $50m net profit in 1H 2004. While revenue rose 9.4% in the period, operating costs rose by 19.2%, with fuel accounting for 32% of this (and rising by a staggering 41% compared with fuel costs in January-June 2004). The airline says the rise in fuel costs was "drastic" and that it faces challenges in the rest of 2005. Ominously, a Morgan Stanley report described prospects for China Eastern's earnings this year as "dismal".

		Group revenue US$m	Group costs US$m	Group op. profit US$m	Group net profit US$m	Operating margin	Net margin	Total ASK m	Total RPK m	Load factor	Total pax. 000s	Group employees
ANA												
YE 31/03	**Year 2001/02**	**9,714**	**9,529**	**185**	**-76**	**1.9%**	**-0.8%**	**87,908**	**57,904**	**64.7%**	**49,306**	
	Apr-Sep 02	5,322	5,194	127	-69	**2.4%**	**-1.3%**	44,429	29,627	66.7%	25,341	
	Year 2002/03	**10,116**	**10,137**	**-22**	**-235**	**-0.2%**	**-2.3%**	**88,539**	**59,107**	**66.7%**	**50,916**	**14,506**
	Apr-Sep 03	5,493	5,362	131	186	2.4%	3.4%	32,494	19,838	61.1%	22,866	
	Year 2003/04	**11,529**	**11,204**	**325**	**234**	**2.8%**	**2.0%**	**87,772**	**55,807**	**63.6%**	**44,800**	**20,530**
Cathay Pacific												
YE 31/12	**Year 2002**	**4,243**	**3,634**	**609**	**513**	**14.4%**	**12.1%**	**63,050**		**77.8%**		**14,600**
	Jan-Jun 03	1,575	1,672	-97	-159	-6.2%	-10.1%	26,831		64.4%	4,019	14,800
	Year 2003	**3,810**	**3,523**	**287**	**168**	**7.5%**	**4.4%**	**59,280**	**42,774**	**72.2%**	**12,322**	**14,673**
	Jan-Jun 04	2,331	2,046	285	233	12.2%	10.0%	35,250		76.1%	6,404	
	Year 2004	**5,024**	**4,350**	**674**	**581**	**13.4%**	**11.6%**	**74,062**	**57,283**	**77.3%**	**13,664**	**15,054**
JAL												
YE 31/03	**Year 2001/02**	**9,607**	**9,741**	**-135**	**-286**	**-1.4%**	**-3.0%**				**37,183**	
	Year 2002/03	**17,387**	**17,298**	**88**	**97**	**0.5%**	**0.6%**	**145,944**	**99,190**	**68.0%**	**56,022**	
	Year 2003/04	**18,398**	**19,042**	**-644**	**-844**	**-3.5%**	**-4.6%**	**145,900**	**93,847**	**64.3%**	**58,241**	
Korean Air												
YE 31/12	**Year 2001**	**4,309**	**4,468**	**-159**	**-448**	**-3.7%**	**-10.4%**	**55,802**	**38,452**	**68.9%**	**21,638**	
	Year 2002	**5,206**	**4,960**	**246**	**93**	**4.7%**	**1.8%**	**58,310**	**41,818**	**71.7%**		
	Year 2003	**5,172**	**4,911**	**261**	**-202**	**5.0%**	**-3.9%**	**59,074**	**40,507**	**68.6%**	**21,811**	
Malaysian												
YE 31/03	**Year 2001/02**	**2,228**	**2,518**	**-204**	**-220**	**-9.2%**	**-9.9%**	**52,595**	**34,709**	**66.0%**	**15,734**	**21,438**
	Year 2002/03	**2,350**	**2,343**	**7**	**89**	**0.3%**	**3.8%**	**54,266**	**37,653**	**69.4%**		**21,916**
	Year 2003/04	**2,308**	**2,258**	**50**	**121**	**2.2%**	**5.2%**	**55,692**	**37,659**	**67.6%**	**15,375**	**20,789**
Qantas												
YE 30/06	**Year 2001/02**	**6,133**	**5,785**	**348**	**232**	**5.7%**	**3.8%**	**95,944**	**75,134**	**78.3%**	**27,128**	**33,044**
	Jul-Dec 02	3,429	3,126	303	200	8.8%	5.8%	50,948	40,743	80.0%	15,161	34,770
	Year 2002/03	**7,588**	**7,217**	**335**	**231**	**4.4%**	**3.0%**	**99,509**	**77,225**	**77.6%**	**28,884**	**34,872**
	Jul-Dec 03	4,348	3,898	450	269	10.3%	6.2%	50,685	40,419	79.7%	15,107	33,552
	Year 2003/04	**7,838**	**7,079**	**759**	**448**	**9.7%**	**5.7%**	**104,200**	**81,276**	**78.0%**	**30,076**	**33,862**
	Jul-Dec 04	5,017	4,493	524	358	10.4%	7.1%	57,402	43,907	76.5%	16,548	35,310
Singapore												
YE 31/03	**Year 2001/02**	**5,399**	**4,837**	**562**	**395**	**10.4%**	**7.3%**	**94,559**	**69,995**	**74.0%**	**14,765**	**29,422**
	Year 2002/03	**5,936**	**5,531**	**405**	**601**	**6.8%**	**10.1%**	**99,566**	**74,183**	**74.5%**	**15,326**	**30,243**
	Year 2003/04	**5,732**	**5,332**	**400**	**525**	**7.0%**	**9.2%**	**88,253**	**64,685**	**73.3%**	**13,278**	**29,734**
	Apr-Jun 04	1,588	1,409	179	159	11.3%	10.0%	25,249	18,167	71.9%	3,800	
	Jul-Sep 04	1,780	1,587	193	215	10.8%	12.1%	26,357	19,959	75.7%	4,050	
	Oct-Dec 04	1,956	1,697	259	291	13.2%	14.9%	26,768	20,274	75.7%	4,201	

Note: Annual figures may not add up to sum of interim results due to adjustments and consolidation. 1 ASM = 1.6093 ASK

AIRCRAFT AVAILABLE FOR SALE OR LEASE - MONTH END

	Old narrowbodies	Old widebodies	Total old	New narrowbodies	New widebodies	Total new	Total
Dec-1999	243	134	377	101	53	154	531
Dec-2000	302	172	474	160	42	202	676
Dec-2001	368	188	556	291	101	392	948
Dec-2002	366	144	510	273	102	375	885
Dec-2003	275	117	392	274	131	405	797
Dec-2004	185	56	241	194	48	242	483
June-2005	165	48	213	205	30	235	448

AIRCRAFT SOLD OR LEASED

	Old narrowbodies	Old widebodies	Total old	New narrowbodies	New widebodies	Total new	Total
1999	582	230	812	989	170	1,159	1,971
2000	475	205	680	895	223	1,118	1,798
2001	286	142	428	1,055	198	1,253	1,681
2002	439	213	652	1,205	246	1,451	2,103
2003	408	94	502	1,119	212	1,331	1,833
2004	321	177	498	1,815	325	2,140	2,638
Mar-2005	18	8	26	160	18	178	204

Source: *BACK* **Notes:** *As at end year; Old narrowbodies = 707, DC8, DC9, 727,737-100/200, F28, BAC 1-11, Caravelle; Old widebodies = L1011, DC10, 747-100/200, A300B4; New narrow-bodies = 737-300+, 757. A320 types, BAe 146, F100, RJ; New widebodies = 747-300+, 767, 777. A600, A310, A330, A340.*

EUROPEAN SCHEDULED TRAFFIC

	Intra-Europe			North Atlantic			Europe-Far East			Total long-haul			Total Int'l		
	ASK bn	RPK bn	LF %	ASK bn	RPK bn	LF %	ASK bn	RPK bn	LF %	ASK bn	RPK bn	LF %	ASK bn	RPK bn	LF %
1997	174.8	110.9	63.4	176.5	138.2	78.3	130.4	96.9	74.3	419.0	320.5	76.5	621.9	450.2	72.4
1998	188.3	120.3	63.9	194.2	149.7	77.1	135.4	100.6	74.3	453.6	344.2	75.9	673.2	484.8	72
1999	200.0	124.9	62.5	218.9	166.5	76.1	134.5	103.1	76.7	492.3	371.0	75.4	727.2	519.5	71.4
2000	208.2	132.8	63.8	229.9	179.4	78.1	137.8	108.0	78.3	508.9	396.5	77.9	755.0	555.2	73.5
2001	212.9	133.4	62.7	217.6	161.3	74.1	131.7	100.9	76.6	492.2	372.6	75.7	743.3	530.5	71.4
2002	197.2	129.3	65.6	181.0	144.4	79.8	129.1	104.4	80.9	447.8	355.1	79.3	679.2	507.7	74.7
2003	210.7	136.7	64.9	215.0	171.3	79.7	131.7	101.2	76.8	497.2	390.8	78.6	742.6	551.3	74.2
2004	220.6	144.2	65.4	224.0	182.9	81.6	153.6	119.9	78.0	535.2	428.7	80.1	795.7	600.7	75.5
July-05	27.9	20.6	73.9	21.6	18.9	87.9	14.7	12.2	83.4	50.7	43.4	85.5	75.1	61.7	82.1
Ann. chng	3.0%	6.5%	2.4	0.6%	2.2%	1.4	8.6%	13.0%	3.2	5.0%	7.2%	1.8	4.1%	7.2%	2.4
Jan-July 05	178.7	118.7	66.4	131.3	108.4	82.6	95.8	75.4	78.7	323.9	261.2	80.7	478.6	365.5	76.4
Ann. Change	3.0%	6.5%	2.4	1.0%	2.0%	0.8	9.6%	11.8%	1.5	5.1%	6.4%	1.0	4.5%	6.4%	1.3

Source: AEA

US MAJORS' SCHEDULED TRAFFIC

	Domestic			North Atlantic			Pacific			Latin America			Total Int'l		
	ASK bn	RPK bn	LF %	ASK bn	RPK bn	LF %	ASK bn	RPK bn	LF %	ASK bn	RPK bn	LF %	ASK bn	RPK bn	LF %
1997	953.3	663.7	69.6	138.1	108.9	78.9	122.0	91.2	74.7	71.3	46.4	65.1	331.2	246.5	74.4
1998	960.8	678.8	70.7	150.5	117.8	78.3	112.7	82.5	73.2	83.5	52.4	62.8	346.7	252.7	72.9
1999	1,007.3	707.5	70.2	164.2	128.2	78.1	113.2	84.7	74.8	81.3	54.3	66.8	358.7	267.2	74.5
2000	1,033.5	740.1	71.6	178.9	141.4	79.0	127.7	97.7	76.5	83.0	57.6	69.4	380.9	289.9	76.1
2001	1,025.4	712.2	69.5	173.7	128.8	74.2	120.1	88.0	73.3	83.4	56.9	68.2	377.2	273.7	72.6
2002	990.0	701.6	70.9	159.0	125.7	67.2	103.0	83.0	80.5	84.1	56.8	67.5	346.1	265.5	76.7
2003	963.1	706.6	73.4	148.3	117.6	79.3	94.8	74.0	80.5	84.2	59.3	70.5	327.2	251.0	76.7
2004	1,014.5	763.6	75.3	164.2	134.4	81.8	105.1	87.6	83.4	96.4	68.0	70.5	365.6	289.8	79.3
July-05	90.2	76.6	85.0	16.7	14.7	87.9	10.4	8.8	84.6	9.4	7.6	81.1	36.5	31.1	85.2
Ann. Change	0.7%	2.9%	1.8	7.5%	8.0%	0.4	12.0%	11.1%	-0.7	8.0%	11.4%	2.5	8.9%	9.7%	0.6
Jan-July 05	592.2	464.5	78.4	100.4	83.1	82.7	67.6	55.9	82.7	63.5	46.9	73.9	231.5	185.8	80.3
Ann. Change	0.0%	3.8%	2.9	7.6%	9.3%	1.2	14.0%	11.0%	-2.2	11.6%	15.9%	2.8	10.5%	11.4%	0.6

Note: US Majors = Aloha, Alaska, American, Am. West, American Transair, Continental, Cont. Micronesia, Delta, Hawaiian JetBlue, MidWest Express, Northwest,Southwest, United and US Airways **Source**: ATA

JET ORDERS

	Date	Buyer	Order	Delivery	Other information/engines
Boeing	20 July	SkyEurope	4 x 737-700		plus 16 options
	20 July	Air Europa	18 x 737-800		plus 16 options
	11 August	Jet Airways	10 x 737-800		
	17 August	UPS	8 x 747-400F		
	7 September	LOT Polish A/L	7 x 787-8		plus 7 options
Airbus	7 September	Wizz Air	12 x A320 family		plus 12 options
Embraer	5 September	Regional	6 x EMB190LR		plus 6 options

Note: Only firm orders from identifiable airlines/lessors are included. *Source: Manufacturers*

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